WEALTH PERSPECTIVES

SUMMER 2017

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The pitfalls of behavioural investing and potential remedies.

WHEN THE TREND IS YOUR FRIEND

Is following the crowd the secret to successful investing?

INVESTING IN A HIGHER RATE ENVIRONMENT

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SMALL-CAP INVESTING

Why do many investors ignore the potential in small-cap companies?

TAYLOR BURKE PARTNERSHIP

CAERUS Capital Group

WELCOME TO THE **LATEST EDITION** OF

WEALTH PERSPECTIVES

in which we focus on the issues that affect your finances.

When the trend is your friend

Watching trends in the price level of an investment, identifying when high and low points are happening, and knowing just the right time to buy or sell is the key to trend investing. While it may not be for everyone, those who adhere to the philosophy of trend investing could see their patience rewarded with a long-term winning strategy.

How ethical funds have evolved

Going back 30 years, being an ethically minded investor wasn't easy. In fact, there was only one ethical fund available. Now, fund managers look at a much wider range of factors in the ethical screening process and the choice is vast, as more and more investors seek funds that reflect the issues they're passionate about.

The hopeful continent

While Western investors may have given up on Africa some years ago, China stepped up to the mark and is now the largest single investor in the continent. With the potential to be one of the highest growth regions in the world, Africa offers great opportunities for future investors and now could be the time to start paying attention.

Investing in a higher rate environment

With interest rates taking off, now is the optimum time to start thinking about the best destination for your cash. But any analysis of worthy investment opportunities needs to take into account not only the rising-rate environment, but also the peculiarities of the current economic context.

Are you a biased investor?

As humans, the things we've experienced in our lives affect our behaviour and become living biases. And this transpires when it comes to investments, too. Behavioural bias can lead to irrational decisions in the world of investing – from impulsive, to the inability to cut one's losses and let a bad investment go.

Small-cap investing

The equity market is made up of companies ranging from multi-nationals to one-man bands. But big doesn't always mean better. The potential in small-cap companies shouldn't be ignored – with new technologies and innovative solutions, smaller companies could form a fundamental part of a long-term investor's portfolio.

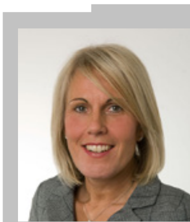
If you wish to discuss your finances or any of the issues raised in this edition, please do get in touch.

Best wishes

Colin Burke

Colin Burke

Partner: Colin Burke
Taylor Burke Partnership



Sandra Taylor

Sandra Taylor

Partner: Sandra Taylor
Taylor Burke Partnership

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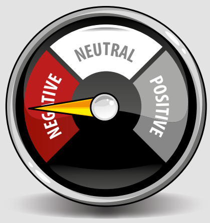
THE CAERUS SENTIMENT DASHBOARD

The CAERUS Sentiment Dashboard provides, in a single view, current attitudes to the main asset classes.

Cash

Government Bonds



Other Bonds

Property

UK

Developed Markets ex-UK

Emerging Markets

Please note, this information is for indicative purposes only.

market COMMENTARY

MAY 2017

Market overview

Globally, equities continue to churn higher with volatility conspicuously absent. Fundamentals remain in the most part on a quiet recovery helped by the continued central bank support. Politics, however, continue to take centre stage with Trump's misjudgements, Macron's success and Corbyn's surprising revival in the UK election polls and, as we go to press, the UK is coming to terms with yet another 'unexpected' election result.

May Indices

Index	May Return (£ base)
FTSE World Index	2.48%
FTSE USA TR GBP	1.59%
FTSE Europe ex-UK TR GBP	5.17%
FTSE Japan TR GBP	3.26%
FTSE 100	4.92%
FTSE all share	4.36%
FTSE EM	1.80%

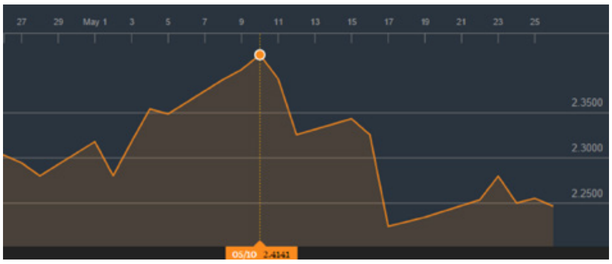
Source FE June 2017. Past performance is not an indication of future returns. The value of investments and any income from them is not guaranteed and can go down as well as up.

United States

Treasuries rallied and equities sold off on the 17th May, driven by increased potential for only the third impeachment in American political history. The US constitution states only the most serious offences should be pursued under this mechanism, specifically "treason, bribery, or other high crimes and misdemeanours". The S&P 500 fell almost 2%, which was a large move given the lack of volatility present in markets. In fact, it was the largest daily fall since September.

Even so, the wall of money continues to exert its pressure and we saw a recovery in markets – closing at new highs by month end. Conversely, the bond market paints a slightly different picture, where yields remained depressed as we close the month. White House success in re-packaging the deal to repeal Obamacare in such a way as to garner sufficient approval from the House of Representatives, was initially received well by the bond market, with 10bps added to the 10 year yield. However, all gains were reversed and more, by month end, suggesting a more gloomy outlook than the story painted by the stock market.

This has all unfolded under a steadying and strong, if slightly less improving fundamental picture. However, one positive enough for the Fed to continue their rhetoric of a further rate rise in June. Unemployment remains low with many other signs of strength in the labour market, while ISM non-manufacturing Purchasing Manager's Index indicators continue to improve. The more important ISM manufacturing PMI disappointed early in the month while inflation was a little 'soggy', but the Fed points to idiosyncratic factors that will be transitory in their impact, curtailing positive price appreciation.



S&P 500 Index

United Kingdom

The FTSE 100 finished the month strongly as an opinion poll implying Jeremy Corbyn had cut the Tories lead to 5 points pressured sterling in combination with signs of an economic slowdown. Having previously rallied to above 1.3 on expectation of a Tory landslide and strong mandate for Brexit negotiations, the recent narrowing of Theresa May's lead has been a boost to the large cap exporters from the currency translation effect. Conversely, the prospect of real wage cuts, as the weak currency imports cost push inflation, is a burden on domestically-focused corporates. Having said that, the labour market remained healthy and retail sales published in May were very positive even if the manufacturing production disappointed.

Europe

Europe began the month with an important victory for the centrists as Macron defeated Le Pen by two to one. Publically, much of the political risk has been lifted and another vote against extremist politics (after the Dutch election) has helped lift European stocks consistently across 2017. Macron has the ambition to make large waves across France, with labour reform, reductions in corporate tax and an ambitious combination of spending cuts and government stimulus. While his fledgling party – La Republique En Marche – may have mirrored its leader in its remarkable rise, for Macron to succeed it needs success in the parliamentary elections scheduled for June.

The election will clearly matter, not least for Macron's labour market reforms, but it should also help highlight the popularity of the European project in France, more so than what could be implied from the presidential contest. Europe-domiciled actively managed funds held more than 162bn in French assets at the end of last year, 45bn more than Germany, emphasising the importance the presidential, and now future parliamentary elections will have on this asset class. Further, average daily flows into ETFs that track European equities have surged to more than $570M since Macron won the first round election, compared to daily outflows of $130M over the past 12 months. Flows imply investors feel the risks have dissipated and are buying into Macron's reform agenda. However, like Trump, he faces many hurdles to success which must moderate our optimism.

Japan

The Japanese labour market continues to tighten, as highlighted last month, overtaking the bubble peak of 1990 for job openings to applicants during May. While Abe's economic stimulus now has companies looking for workers, there is still little upward pressure on wages. One difference to 1990 needs to be pointed out. Back in the boom years, it was a rapid growth in jobs creating the labour market tightness, whereas today it is a lack of supply. More clearly positive news for the administration was an unexpected increase in Preliminary GDP growth for Q1, up to 0.5% from 0.3% the previous quarter.

Emerging Markets

Less than two weeks after China said it would open up its domestic market to US rating agencies, Moody's has cut the country's credit rating for the first time in 25 years, given the financial and economic risks they observe. While this has had little immediate impact – domestic investors paying little attention to this foreign ratings agency – the medium term impact could be larger, given many sovereign wealth funds have explicit mandates that require bonds above a certain rating. The downgrade leaves China on a par with Israel, the Saudis and the Czech Republic. Elsewhere, Brazilian stocks fell over 8%, alongside currency depreciation, as the story broke that President Michel Temer had endorsed bribe payments. Constitutional constraints make a general election unlikely before 2018, implying any form of exit from office by the president will freeze economic reforms, leaving growth potential in hiatus.

** All performance data quoted in this article is derived from FE Analytics*

WHEN THE TREND *is your friend*

Is the secret to successful investing to be found in following the crowd?

When it comes to fashion, haircuts, or social media topics, trends will come and go. Trend investing, however, has been around for ages – and isn't about to go away soon.

To understand what trend investing is, it's probably best to start with what *it's not*. Despite the name, it's not about following current events to develop an investment strategy (stocks that would perform well when interest rates and inflation are on the rise, for example).

Instead, it's focused on watching for trends in the price level of an investment, and recognising when to buy (and sell) at just the right time. We've all heard of the expression 'Buy low, sell high'. Trend investing is about identifying when those high and low points are happening, through a technical analysis of price movements over time.

There are too many ways of choosing investments to list here, but a vast majority of them look at the underlying fundamentals of the investment. For example, if you're picking a stock to buy,

‘We know that prices move up and down. They always have and they always will. My theory is that behind these major movements is an irresistible force. That is all one needs to know.”

Jesse Lauriston Livermore, ‘How to Trade in Stocks’, 1940

you might look at the company’s financial health, earnings and management. You could consider the current stock price relative to what you think it could some day be; is it a good value, or is there potential for growth? Almost all of these methods involve analysing the investment on its own merits.

Trend investing, on the other hand, looks only at the behaviour of the stock price over time, irrespective of anything else. It’s a systematic approach that doesn’t take into account short-term fluctuations but follows set price points at which to buy in after a price trend has started, follow the trend upwards, then sell. The same principle applies to a downward trend; identify the point at which to cut your losses and either sell the holding or reduce your position to minimise risk. And to be clear, it’s not an act of ‘jumping on the bandwagon’ as such, but the application of a technical analysis to recognise price patterns over time.

Fundamental analysis considers:	Trend investing considers:
Company balance sheets	Price trends
Current and projected price	Timing
Intrinsic value	Systematic rules

Following set rules, and overlooking temporary investment sentiment, calls for a certain discipline and belief in the machinations of the market. In other words, trend investing is not for the faint of heart. But, for those who adhere to its philosophy, it’s a method that rewards patience and timing just as much as ‘fundamental’ investing rewards more traditional approaches.

One of the most famous proponents of trend investing was a man called Jesse Lauriston Livermore. At the tender age of 15, he was a ‘board boy’ at the Boston trading firm, Paine Webber, posting updated prices on the board for the eyes of speculators, in the last days of the 19th century. By watching the trends of stock prices, the young man soon concluded they were not random, but predictable. Within a year, at age 16, he’d left Paine Webber and started trading for himself – sometimes wearing a disguise. He amassed (and lost) several fortunes over his fascinating life and, to this day, trend investors still adhere to his core methods.

Active traders have a few favourite maxims that sum up this style of investing. ‘Don’t fight the tape’ is a reference to the ticker tape that shows the most recent prices of an investment – much like the board a young Livermore once updated back in the 1890s. ‘The trend is your friend’ conveys a similar message; don’t bet against the direction the market is going in. Ride the trend until it the reverse trend begins, then take your profit and move on.

Not every individual trade will make money. Trend investors know this, and accept it. But their conviction lies in the overall force of the market. In aggregate, the method of applying technical analysis to capture gains on the upside and reduce risk on the downside is a winning strategy over the long term.

Are you a BIASED INVESTOR?

The pitfalls of behavioural investing and potential remedies.

Why do investors, especially retail investors, make the same behavioural mistakes again and again? Whether buying at the top, selling at the bottom, falling in love with a favourite stock, or ignoring clear evidence when it does not chime with our view, we are all prone to irrational decisions.

Psychological influences are alive and well in investment. As humans, we are a complex amalgam of the various experiences and conditions we've experienced in our lives, which leave an indelible mark. As much as we might want to escape some of these influences, they lie within us, dormant or otherwise. They affect our behaviour and become living biases. In the world of investment, these biases or emotional idiosyncrasies are generally not advantageous.

Short cuts and anchoring

Behavioural bias is easy to diagnose, extremely difficult to shake. Through our life experiences, we may, for instance, have become convinced that it pays to be quick and nimble in carrying out our tasks. We may carry this into the investment world and seek to make quick or impulsive decisions, looking for short cuts. Faced with a tidal wave of information through numerous channels, one of the short cuts that we both consciously and unconsciously make in trying to process this endless stream of information is to aggregate things, look for the typical and the average, and extrapolate the likelihood of future events based on that. This is often referred to as 'anchoring'. We are relaxed with a certain view of things and effectively lower our anchor at that point and indeed return to it when times get tough, almost like a child with his comfort blanket. We begin to systematically ignore or dismiss incidents or arguments that contradict our tightly held views – exactly when the red light should be flashing.

A simple, topical example of anchoring might be the received wisdom of doing well by buying high-dividend companies. We are often told that in a low-growth period, dividends make up more of the return and that high-dividend companies always prosper. The 'anchored' investor will simply buy the stocks in question without perhaps checking what happens to such stocks if growth rates pick up or if the dividend cover is inadequate.

Sell aversion!

One of the most notorious and widespread examples of behavioural bias is the inability to cut one's losses and sell a bad investment. Hanging on to a bad investment as the share price falls is common, especially if it is one that the investor has done extensive research on and believes in.

This is where hubris is a shadowy presence, lurking close to and playing with the reason of the investor. It is difficult to sell something one has invested intellectual as well as real capital in. It is easy to strap the blinkers on as bad news comes out and the share price falls, and prepare to ride out the 'temporary' storm, only to go on to lose one's shirt!

What can one do?

How does one stay rational in an emotional world?
The better fund management houses and investors have objective processes or sets of rules they follow, which purposely avoid or limit behavioural activities. One example might be a stop-loss of 10% on all investments, whereby if a stock falls below the purchase price by 10%, it is automatically sold. While this might not always be the right decision, it does take away some of the subjectivity that can all too easily creep into investment decisions.

Another reasonable and generally beneficial policy is to make as few decisions as possible and become a long-term investor, buying and holding. If one can afford to lock money away for years, even decades, then that is generally a good way to get rich slowly, given stocks outperform cash over time. Even bad initial decisions can come good in the long run.

Regular investing on a monthly basis, or what is sometimes referred to as 'pound-cost averaging', particularly for those minded to build up capital through an ISA or a pension over a long period, is also sensible and avoids the timing issues associated with lump-sum investing.

The best investment approaches are methodical, repeatable, rigorously implemented, and almost boring! However, they will cut through the behavioural biases to which we are all susceptible.

"One of the most notorious and widespread examples of behavioural bias is the inability to cut one's losses and sell a bad investment."

How ethical funds HAVE EVOLVED

If you were an ethically minded investor back in 1984, there was only one option:- the F&C Stewardship Fund, launched that year as the first ever 'ethical' fund. Since then, the market for ethical investing has exploded and become more nuanced – with ethical, sustainable and responsible investment options.

Investors can choose funds that reflect issues they're passionate about, and evidence suggests that investments in companies that pay heed to environmental, social and governance (ESG) concerns generate better returns.

The first ethical funds were guided by a screening process, whereby the fund manager would avoid companies that (arguably) damaged society or the environment. This included areas like alcohol, tobacco, gambling and munitions. By contrast, the fund manager would search for companies that actively supported society and the environment.

From ethical to 'responsible' investing

This ethical screening process has stood the test of time but the criteria – what we consider to be an 'ethical' investment – has become more nuanced. Fund managers look at a much wider range of factors, and business practices are also scrutinised. This approach – looking at all facets of a company's conduct, and its impact on the wider world – is a crucial part of what's known as 'responsible' investment. Put simply, responsible investment is rooted in a belief that the global financial system should be economically efficient and sustainable.

The PRI – a new kitemark?

As of May 2017, 1,707 investment managers, asset owners and service providers from over 50 countries had committed to the Principals for Responsible investment (PRI). Formed in 2006 and backed by the United Nations, the PRI aims to incorporate ESG issues into investment companies' investment analysis and decision-making. But how does an investment manager's commitment to the tenets of responsible investing help the Clients they serve?

Let's consider Volkswagen. Back in 2015, Volkswagen's share price took a hit after news emerged that the company had cheated in emissions tests. This was bad news for Clients investing in funds that held shares in Volkswagen. But according to the Financial Times, some asset managers had raised eyebrows at Volkswagen's governance and labour standards before the scandal unfolded. Their focus on these areas shielded their investors from the pain others experienced.

For investors in mutual funds, it's easy to find out if fund managers adhere to the PRI principles. Most signatories will display the PRI logo and explain why they're involved. If you can't find this information online, why not contact the company to ask what their stance is? It is your investment at stake, after all.

"The market for ethical investing has exploded and become more nuanced."

The value of an Investment can go down as well as up and you may get back less than the amount invested.

The hopeful CONTINENT?

Somewhere at the beginning of the noughties, Western investors gave up on Africa. For too long, the news from the continent had been dominated by political turmoil, vicious civil wars, famine and a seemingly endless tide of corruption. Africa was even declared 'The Hopeless Continent' by the Economist in 2000.

For private investors, the problems of investing in Africa have been compounded by the fact that all of Africa's major products – oil, gas, foodstuffs, gold, gemstones, cocoa and coffee – are subject to the highs and brutal lows of the commodities market. The only way out of the 'resources curse' is for African economies to develop their services and manufacturing sectors, and increase productivity.

While the West has been shrugging its shoulders, and looking the other way, China has had no hesitation about stepping in, either by investing directly or underwriting investments, on a huge scale. China is now the largest single investor in the continent, and has also become Africa's most significant trading partner, providing $160 billion in trade in 2015. African leaders have looked at China – with its explosion in urbanisation, and enormous expansion in economic growth, wealth and infrastructure over a short period of time – and seen this as a pattern for how Africa's economies could develop.

Chinese investors have offered support for African agribusinesses, manufacturing, infrastructure and connectivity between regions, renewable energy and skills development. Meanwhile, Chinese private investment and government loans have allowed ports, airports and railway infrastructure to be developed. China is building factories in Ethiopia, and roads and railways through the heart of Africa to connect to its ports in the east – all with the aim of bringing commodities and food to China.

Thinking – and getting things done – on this vast scale is the Chinese way. Compare the years the UK has agonised over a third runway at Heathrow, with the plan to construct the world's largest airport in Beijing. This is the ambitious scale of thinking that Africa demands. Also, Chinese money – both private and public – is loaned or invested in Africa with few conditions, and without the West's demands for improved governance, eco-friendliness, sustainability or inclusivity. Perhaps the West asked too much?

Over the coming decades, Africa could offer boundless opportunities for growth. The continent has a population of one billion, but only 37% of this population is urbanised, and this will soon change. With higher incomes, Africa, like China before it, will develop an enormous middle class, and the Financial Services, manufacturing and construction industries that come with it.

For future investors, the returns from Africa could be enormous, as it has the potential be one of the highest growth regions in the world. Already, between 2010 and 2014, the service sector has jumped from 44% to 48%, and manufacturing from 17% to 23%. Africa also has demographics on its side. By 2034, the continent will have the world's largest working-age population. As the West and Asia grow older, Africa will be the young and dynamic continent. Urbanisation should lead to industrialisation and purchasing power, while entrepreneurs will undoubtedly make money in the high-growth phases, as consumer spending rises.

And while China is already fully engaged, Brazil and India are hurrying to join the 21st century's 'scramble for Africa'. Now could be the right time for Western investors to pay closer attention to Africa's opportunities.

Sources: http://www.worldbank.org/en/news/opinion/2015/06/30/africa-still-poised-to-become-the-next-great-investment-destination • http://www.economist.com/printedition/2000-05-13 https://businesstech.co.za/news/general/138943/the-safest-and-most-dangerous-countries-in-africa • http://www.worldbank.org/en/events/2016/09/07/second-investing-in-africa-forum http://nationalinterest.org/feature/what-china-knows-about-africa-the-west-doesnt-16295?page=2

Promising destinations:-

INVESTING IN A HIGHER RATE ENVIRONMENT

In recent years, interest rates have become oddly akin to a tourist-packed aircraft, stranded on the runway as it awaits a signal to take off.

Eager to shrug off the cloudy overhang of the 2008 economic crisis, market participants have been cheering for rising interest rates, which would mark the return to a fully-fledged growth environment.

As the Federal Reserve raised its rates in March to 1% and asserted its intention to hike twice more in 2017, the long stall appears to be coming to an end. But with rates taking off, what are the attractive destinations for investors' cash?

Traditional targets are not necessarily a sure bet this time. Though rates are commonly raised when economic activity overheats markets, the current rate-hiking cycle arrives at a time when economic growth rates remain tepid, despite nearly a decade having elapsed since the financial crisis. Recognising this, the Fed is aiming to raise the target fund rate to 3%, a historically low long-run level.

Therefore, any analysis of worthy investment opportunities must take into account not just the rising-rate environment, but also the peculiarities of the current economic context.

Regional banks are a promising prospect

The prolonged period of squeezed margins and reduced profitability led banks to tighten their costs; as the long-term rates improve lending margins, these financial institutions stand to benefit. Additionally, further acceleration in economic activity is likely to result in increased demand for loans.

The outlook for the consumer sectors remains uneven

Strong inflation and low unemployment are usually evident prior to rate-hiking cycles, and these twin forces have historically also resulted in wage inflation. But not this time. Though inflation has been gathering pace and unemployment continues to fall both in Europe and the US, wage stagnation persists. We may see rising retail prices starting to bite earlier, making consumers reluctant to spend more.

However, opportunities remain in the consumer sector, and evidence suggests the place to find them is Europe. As ECB Executive Board member, Yves Mersch, recently noted, recovery in the region was marked by a convergence of country-specific growth rates, and driven by domestic demand rather than exports. In the process, European consumers opted to increase spending rather than savings, in contrast with their US counterparts who focused on setting money aside.

Yet turbulence lies ahead, with the Brexit negotiations set to begin in earnest after the UK elections. Sterling has already weakened considerably following the UK vote to exit the EU, and this is expected to feed into higher inflation in the near term. Further ahead, as trade agreements are revisited, consumers in both continental Europe and the UK may face steeper costs on both staples and discretionary spending.

Technology companies are an eye-catching proposition

Non-financial corporations have been accumulating cash ever since the financial crash. According to ratings agency Moody's, in the US alone such companies have accumulated over $1.77 trillion, and over half this amount is held by technology firms. Apple leads the pack, holding in excess of $256 billion in cash, with significant hoards maintained by Microsoft, Alphabet, Cisco and Oracle.

Cash-rich companies stand to benefit from rising rates in multiple ways. In addition to earning more on their cash reserves, they also become comparatively more attractive when debt-ridden companies are faced with rising financing costs.

But one reason the cash continues to pile up is that much of it is held overseas, to avoid the US's punitive corporate tax rate. President Donald Trump has repeatedly asserted that reducing the corporate tax burden is a key priority for his administration, and has already begun shaping a legislative plan to address the problem. Successfully reducing tax rates is likely to lead to the repatriation of some of the tech companies' cash, ultimately boosting technology-stocks dividends.

In the meantime, tech companies are busy investing; private sector investment in research and development is at a 20-year high, both in the US and in Europe. This is not only likely to result in a new product pipeline, but also a trickle down of innovation to smaller companies, helping alleviate the productivity slump that has hampered the economic recovery. For those runway-stranded investors, still waiting for interest rates to take off, some tech companies may offer a particularly sunny destination.

Sources: Fed target rate
weak GDP growth rates: : http://www.tradingeconomics.com/united-states/gdp-growth-annual
target rate 3%: https://www.usatoday.com/story/money/2017/03/15/federal-reserve-interest-rates-economy-janet-yellen-mortgages-credit-cards/99186568/

Consumer sectors
https://www.ecb.europa.eu/press/key/date/2017/html/ecb.sp170508.en.html • http://www.tradingeconomics.com/united-kingdom/consumer-spending
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Tech companies cash
https://www.moodys.com/research/Moodys-US-corporate-cash-pile-led-by-tech-sector-to--PR_357576
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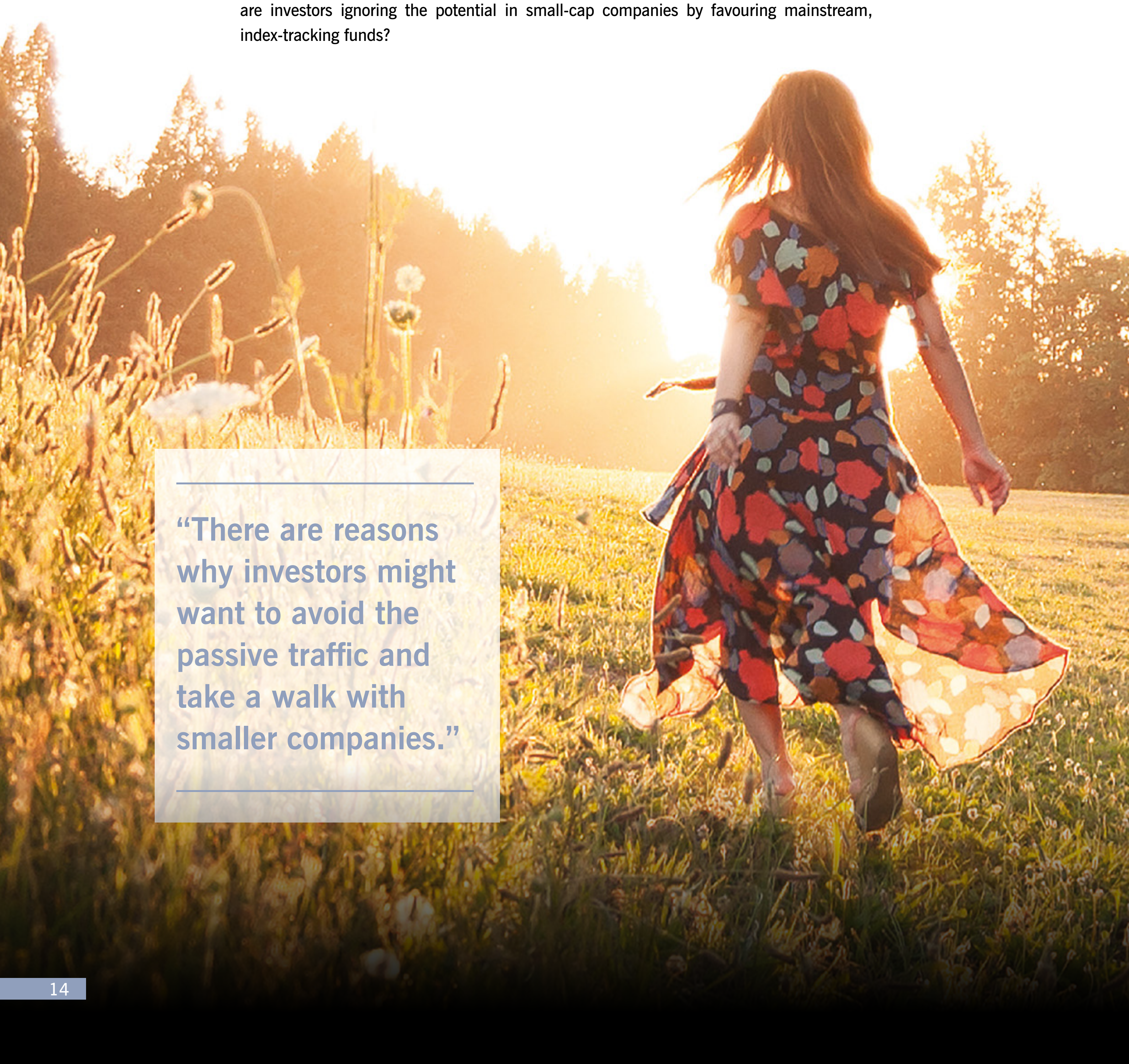
Small-cap INVESTING

From multi-national mining corporations to geeks inventing the next game changer in garages, the equity market includes companies of every shape and size. But as the investment map is redrafted to accommodate increasing vehicles for passive investment, are investors ignoring the potential in small-cap companies by favouring mainstream, index-tracking funds?



> **"There are reasons why investors might want to avoid the passive traffic and take a walk with smaller companies."**

Passive passers-by

Passive (index tracking) investing has soared in popularity in recent years, and increasing numbers of investors are becoming concentrated into limited areas of the market. If they were passengers, they would all be crammed onto the same train. For active, small-cap investors with the capacity and expertise to research this unloved area of the market, opportunities abound to unfold a Brompton bike and beat the crowds by finding overlooked and undervalued companies.

Mind the research gap

Amid the shift towards passive investing, a number of investment institutions have reduced their numbers of research analysts, in both equities and bonds. Equity analysis is often focused on large-cap sectors, such as banking, oil and gas, and mining, but these form a relatively small proportion of the small-cap universe, meaning that small-cap equities often fall even further off the radar. In the market gap beside the platform of standard investments, in areas such as small-cap equities where there is lower analyst coverage, researchers and fund managers who focus on these untapped sectors can step across and uncover mispriced value in unfashionable destinations.

Taking the stairs: growth potential

Innovation is at the heart of smaller companies. Unlike well-established household brands that are already at the top of the escalator, smaller companies are on the first steps to success. Although some of these companies might falter on the way, those that make it to the top have the whole staircase to ascend in terms of earnings, compared to their larger counterparts already on the final step; they also have the potential to trip up complacent market leaders with new technologies and savvy solutions. The core task for equity analysts is to establish whether risk and reward are balanced, and to spot those companies with the stamina to race up the stairs, overtaking their sluggish, large-cap counterparts.

Engineering works: performance and risks

As any disclaimer will tell you, 'past performance is not a guide to future returns', but it is interesting to note that, as shown by the chart on the right, over the past 10 years, small-cap and mid-cap equities have outperformed large-cap companies in the UK.

Small-cap, mid-cap and large-cap 10-year returns

SOURCE: Thomson Reuters Datastream, as at 30.04.2017

The FTSE Small Cap Index and the FTSE 250 (mid-cap) Index were hit hard by the Brexit referendum in June 2016, primarily due to currency movements. The value of sterling plummeted, and while larger multinational corporations in the FTSE 100 benefited from the fact that their overseas earnings became more valuable in sterling terms, more domestically-focused smaller companies were stuck with earnings in a devalued currency. Additionally, shares of smaller companies tend to be less liquid (harder to buy and sell) than those of larger firms, and therefore more susceptible to volatility.

Nevertheless, for active investors, sudden and indiscriminate market disruptions can represent buying opportunities. For long-term investors in small-cap equities, the key point is that while this asset class will be more volatile, for those with the appropriate time horizon to sit out such disruptions, there is potential for a high-speed train to follow.

An alternative route

All investment entails risk, but companies in different parts of the market-capitalisation spectrum are affected differently by market events. Smaller-cap companies have exposures to different sectors and often different geographical markets, compared with large-cap leaders. Most investors will have a portfolio that is split across asset classes, some which should provide protection during volatility, and others that have potential for higher returns in market rallies. As part of a balanced portfolio, small-cap equities are a clear candidate for long-term investors who can take on some additional risk, and who want to diversify their investments by stepping off the beaten track and including an asset class with attractive potential for growth.

Sources: https://www.ft.com/content/fe07f6a0-e738-11e6-967b-c88452263daf

LEADING *Indicators*

United Kingdom Stock Markets	3 months	6 months	1 year
FTSE 100[1]	4.87%	12.22%	25.64%
FTSE 250[1]	8.40%	15.00%	19.70%
FTSE All Share[1]	5.52%	12.81%	24.70%

Source: Financial Express Analytics 24th May 2017

American Stock Markets	3 months	6 months	1 year
NASDAQ 100[1]	7.28%	18.20%	29.91%
S&P 500[1]	2.05%	10.18%	18.27%

Source: Financial Express Analytics 24th May 2017

European Stock Markets	3 months	6 months	1 year
CAC 40[1]	12.09%	19.92%	24.54%
DAX[1]	7.64%	19.16%	25.56%
DJ Euro Stoxx[1]	10.67%	20.75%	23.49%

Source: Financial Express Analytics 24th May 2017

Other Stock Markets	3 months	6 months	1 year
Hang Seng[1]	6.79%	13.64%	32.94%
MSCI Emerging Markets[1]	6.27%	14.40%	25.26%
Nikkei[1]	2.38%	7.69%	19.66%

Source: Financial Express Analytics 24th May 2017

Gilts	3 months	6 months	1 year
FTSE British Government 10 – 15 years[1]	1.01%	5.02%	7.33%

Source: Financial Express Analytics 24th May 2017

Property	3 months	6 months	1 year
Halifax Property Index[1]	-0.04%	0.96%	3.51%
IPD UK All Property[1]	2.28%	5.08%	4.00%

Source: Financial Express Analytics 24th May 2017

Savings	3 months	6 months	1 year
Moneyfacts Instant Access[1,2]	0.09%	0.19%	0.46%
Moneyfacts 90 days notice[1,3]	0.12%	0.25%	0.61%

Source: Financial Express Analytics 24th May 2017

Inflation	3 months	6 months	1 year
UK Consumer Price Index	0.78%	1.48%	2.49%

Source: Financial Express Analytics 24th May 2017

Interest Rates	3 months	6 months	1 year
Bank of England	0.06%	0.12%	0.30%

Source: Financial Express Analytics 24th May 2017

Notes

1 Gross return bid-bid, annualised.

2 Moneyfacts Average of instant access accounts, £10,000 invested, total return, gross.

3 Moneyfacts Average of 90 day notice accounts, £10,000 invested, total return, gross.

TAYLOR BURKE
PARTNERSHIP

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